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European Commission Proposes Mandatory Corporate Sustainability Due Diligence and Climate Change Plans

The Proposed new EU Directive would:

- (1) impose human rights and environmental due diligence, prevention and mitigation obligations on large or high-risk companies, including non-EU companies generating significant revenue in the EU, extending to their subsidiaries and global value chains; and
- (2) require adoption of corporate climate change plans ensuring a company's business model and strategy are compatible with limiting global warming to 1.5°C, including, in some circumstances, factoring in climate change into executive compensation and setting corporate GHG emissions reduction objectives.

SUMMARY

On February 23, 2022, the European Commission (the "Commission") published its draft Directive on Corporate Sustainability Due Diligence (the "Directive").¹ Under the Directive, European Union (EU) Member States would be required to adopt implementing legislation requiring in-scope companies to both identify and (where relevant) prevent, end and/or mitigate adverse impacts of their operations and activities (extending to their subsidiaries and global value chains) on human rights and the environment (including with respect to climate change). The obligations under the Directive are extra-territorial and will apply to certain companies generating significant revenue in the EU even if they do not necessarily have a physical presence within the EU. If approved by the European Parliament and Council, Member States will have two years to transpose the Directive into their national laws.

BACKGROUND

The European Union (EU) has been active in recent years in developing mandatory corporate ESG-related due diligence and compliance-focused measures, which fall within its broader sustainability/ESG policy agenda. For example, the EU Non-Financial Reporting Directive (NFRD)² requires certain large listed EU companies to disclose information on certain ESG matters, including any ESG-related due diligence processes implemented. There are also a number of sector-specific legislative acts, such as the EU Conflict Minerals Regulation,³ which requires EU companies to ensure that they import tin, tungsten, tantalum and gold from responsible and conflict-free sources and establish mechanisms for conducting due diligence (such as independent audits of supply chain due diligence). In addition, the EU Sustainable Finance Disclosure Regulation (SFDR)⁴ requires certain financial market participants within the EU to publish a statement on their due diligence policies with respect to any adverse impacts of their investment decisions on sustainability factors. In November 2021, the Commission submitted proposals to introduce mandatory corporate due diligence obligations to ensure that certain products are not linked to deforestation or forest degradation.⁵

There has also been growing proliferation of national mandatory due diligence regimes within Europe. For example, in 2017, France enacted supply chain legislation requiring large French companies to undertake due diligence in respect of their contractors and suppliers aimed at preventing adverse human rights and other ESG impacts.⁶ Similarly, in June 2021, the German parliament passed legislation requiring companies to take measures to prevent human rights violations in their supply chains.⁷ A number of other EU Member States are in the process of adopting similar legislative measures. In March 2021, the European Parliament adopted a proposal for the Commission's consideration for a new EU directive mandating corporate human rights and environmental due diligence.⁸

SCOPE OF ENTITIES COVERED

These "Group 1" companies will be required to comply with the Directive (as implemented by the relevant Member State) within two years of its enactment:

- **Large EU companies:** All companies formed under the laws of an EU Member State with over 500 employees and an annual net turnover exceeding €150 million worldwide.
- **Non-EU companies with significant EU revenues:** All companies formed outside the EU with an annual net turnover in the EU exceeding €150 million.

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These “Group 2” companies will be required to comply with the Directive (as implemented by the relevant Member State) within four years of its enactment:

- **Mid-cap EU companies in high impact sectors:** EU companies with more than 250 employees and a net turnover of €40-150 million worldwide, provided that at least 50% of this turnover was generated in one or more of the following “high impact” sectors:
 - Manufacturing of textiles, leather and related products (including footwear) and wholesale trade of textiles, clothing and footwear;
 - Agriculture, forestry, fisheries, manufacturing of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food and beverages; and
 - Extraction of mineral resources (irrespective of where they are extracted), including crude petroleum, natural gas, coal, lignite, metals and metal ores; manufacturing of certain metal products; and the wholesale trade of mineral resources, basic and intermediate mineral products (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products).
- **Non-EU companies with EU revenues from high impact sectors:** Non-EU companies that generated annual net turnover of €40-150 million in the EU, of which at least 50% (calculated on a global basis) derives from the high impact sectors noted above.

The Commission estimates that approximately 13,000 EU companies and 4,000 non-EU companies will fall within the scope of the Directive.

CORPORATE SCOPE OF OBLIGATIONS

The obligations imposed under the Directive will apply to the operations of in-scope companies and those of their subsidiaries and the company’s “value chain” operations carried out by entities with whom the company has an “established business relationship.” “Established business relationships” capture direct and indirect commercial relationships which are “expected to be lasting” and “do not represent a negligible or merely ancillary part of a value chain.”

A company’s “value chain” covers activities related to the production of goods or provision of services, including product development, use and disposal of the product and related upstream and downstream established business relationships of the company. The “value chain” of financial institutions providing financial services is defined as the activities of their clients⁹ and of other companies in the client’s group whose activities are linked to the relevant value chain contract.

DUE DILIGENCE OBLIGATIONS

In-scope companies will be required to:

1. **Integrate human rights and environmental due diligence into corporate policies.** Relevant policies shall include descriptions of the company’s approach to due diligence, its code of conduct, and the processes established to implement due diligence. Larger entities are required to update and publicly report such policies annually.

2. **Identify actual or potential adverse human rights and environmental impacts arising from their own operations, those of their subsidiaries and from their established business relationships throughout their value chains.** Companies shall, where relevant, carry out consultations with potential affected groups, including workers and other relevant stakeholders to gather information on actual or potential adverse impacts. Group 2 companies are only required to identify their impacts relevant to their respective high risk sector(s). Financial institutions providing credit, loan or other financial services will need to identify actual and potential adverse impacts only before providing these services.
3. **Prevent or, if not immediately possible, mitigate such potential impacts and end actual adverse impacts.** Required corporate actions may include implementation of a prevention action plan in consultation with affected stakeholders, seeking contractual assurances that ensure compliance with the company's code of conduct from counterparties with whom the company has a direct business relationship (including "contractual cascading" through a value chain), and the establishment of measures to verify compliance. Contractual assurances shall be accompanied by appropriate compliance verification measures. If prevention or mitigation is unsuccessful or an actual adverse impact cannot be ended, companies shall refrain from extending or entering into new relationships with partners connected to such impact and, if the impact is severe and if legally possible, terminate existing relationships. Additionally, companies are required to end or minimize the relevant adverse impact, including by the payment of damages to affected persons or communities proportionate to the significance and scale of the impact and the contribution of the company's conduct.
4. **Maintain a human rights and environmental complaints procedure.** Entities are required to enable complaints to be submitted by (i) affected persons; (ii) representatives of such individuals; and (iii) civil society organizations active in areas related to the relevant value chain. Complainants shall be entitled to meet with company representatives at the appropriate level.
5. **Monitor the effectiveness of the due diligence policies and measures.** Companies must carry out annual reviews of their own operations and measures, as well as those of their subsidiaries and their established business relationships in their value chains.
6. **Publish annually a public statement relating to the Directive requirements.** Companies not subject to the NFRD will be required to publish an annual statement to communicate the relevant due diligence and prevention and mitigation actions taken by the company during the previous year.

OBLIGATION TO ADOPT A CLIMATE CHANGE PLAN

In addition to the above human rights and environmental due diligence-related requirements, the Directive will require Group 1 companies to adopt a corporate plan to ensure that their business model and strategy are compatible with the Paris Agreement goals of limiting global warming to 1.5°C. Plans are expected to identify the extent to which climate change is a risk for (or an impact of) the relevant company's operations. If climate change is or should have been identified as a principal risk or impact, the company is required to include emission reduction objectives in its plan. Companies shall also duly take into account their climate change plans when setting variable director and executive remuneration, if such remuneration is already linked to the company's business strategy and long-term interests and sustainability.

ENFORCEMENT MECHANISMS

The Directive sets out various enforcement mechanisms:

1. **Regulatory Supervision and Exclusion from Public Support:** Member States will be required to impose sanctions (including fines and compliance orders), which must be “effective, proportionate and dissuasive” and may include financial penalties based on a company’s turnover. Companies will be required to certify that no such sanctions have been imposed on them when applying for public support. The Commission will also establish a European Network of Supervisory Authorities to ensure a coordinated approach to supervision.
2. **Civil Liability:** The Directive will also require Member States to ensure companies are liable for civil damages in circumstances where their failure to comply with the mandated due diligence, mitigation or remediation obligations leads to damage. Companies will not be held liable for damages caused by an adverse impact arising as a result of the activities of an indirect partner with whom it has an established business relationship, provided that the company has obtained the requisite contractual assurances from its direct partner (unless it was unreasonable to expect that the action actually taken, including with respect to verifying compliance, would be adequate to prevent, minimize, end or mitigate the adverse impact).
3. **Director/Executive Duties:** The Directive will require Member States to ensure members of management bodies (or the CEO if there is no management body) of in-scope EU companies are responsible for establishing and overseeing the implementation of the required due diligence actions and adapting corporate strategy in light of actual and potential adverse human rights or environmental impacts. CEOs and other members of administrative, management or supervisory bodies (or others performing similar functions) of companies will also be required to consider, where applicable, the human rights, climate change and other environmental consequences of their corporate decisions, on a short- medium- and long-term basis.

IMPLICATIONS

The Directive, if approved by the European Parliament and Council, will represent one of the most ambitious ESG-related corporate regulations to date, especially in light of its extraterritorial reach, requirement for businesses to align their strategies with a 1.5°C warming scenario, and more generally the substantive duties it imposes.

Companies should begin to assess whether they or any of their subsidiaries fall within the proposed scope of the Directive and, if so, what steps will need to be taken to ensure compliance with it. This could require making significant changes to business plans and strategies, corporate procurement and contracting policies, corporate governance and board oversight, executive compensation and internal monitoring and compliance functions.

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ENDNOTES

- 1 European Commission Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, COM(2022) 71 final.
- 2 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014. On 21 April 2021, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would extend the existing non-financial reporting requirements.
- 3 Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017.
- 4 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019.
- 5 European Commission Proposal for a Regulation of the European Parliament and of the Council on the making available on the Union Market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010.
- 6 Loi no. 2017-399 du 27 Mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre.
- 7 Gesetz über die unternehmerischen "Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten" (Supply Chain Act).
- 8 See our previous publication covering this proposal and other business and human rights developments [here](#).
- 9 This excludes small and medium-sized enterprises (SMEs), which do not need to be within the scope of the due diligence.

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